

## Internal Revenue Service

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Department of the Treasury

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PLR-140446-15

Date:

November 12, 2019

### Legend:

Taxpayer =

State 1 =

State 2 =

State 2 Act =

Date 1 =

Date 2 =

LP =

City =

Year =

Amount 1 =

Amount 2 =

Amount 3 =

a =

b =

c =

d =

e =

Dear :

This is in reply to a letter dated November 24, 2015, and supplemental correspondence, submitted on behalf of Taxpayer by its authorized representatives. Taxpayer requests a ruling under § 856(c)(5)(J) of the Internal Revenue Code with respect to the qualification under § 856(c)(2) of income attributable to certain Reimbursement Payments (defined below) received by Taxpayer.

#### FACTS

Taxpayer, a State 1 corporation, represents that it is a real estate investment trust ("REIT") formed for the purpose of owning and operating real estate. Taxpayer uses an accrual method of accounting and a calendar tax year. Taxpayer owns a percent of a joint venture, which is treated as a partnership for U.S. federal income tax purposes ("JV"). On Date 1, JV acquired an interest in a mixed-use residential, retail, and office development in City, State 2 (the "Project") for Amount 1. As part of the acquisition of the Project, JV also acquired rights and obligations under an Economic Development Agreement ("EDA") described below. The Project and the EDA were previously owned by LP, a State 1 limited partnership.

State 2 Act authorizes State 2 municipalities to provide assistance for economic development. Specifically, State 2 municipalities are authorized to provide for administration of one or more programs including programs for making loans or grants of public money. The programs must serve the purpose of promoting state and local development by stimulating business and commercial activity within the municipality. On Date 2, City entered into the EDA under State 2 Act with LP as an incentive for LP to make certain improvements to the Project: water, stormwater, wastewater and drainage improvements; road improvements; and a public park (the "Public Improvements"). Under the EDA, the Public Improvements must be (i) actually constructed, (ii) conveyed to and accepted by City (with the exception of the public park), and (iii) open to the public and available for public use. The EDA obligated LP to maintain the public park, and City to maintain the other Public Improvements. LP was also required to grant an easement to City to allow for public use of the park.

The costs of the Public Improvements totaled Amount 2. The EDA requires City to reimburse LP for amounts expended for the Public Improvements (the "Reimbursement Payments") after certain Public Improvement construction milestones

are met (the "Reimbursement Date"), subject to the requirement that the development of the Project leads to the creation of a specified number of jobs. From the Reimbursement Date forward, at the end of each calendar year, City must determine the amount of sales tax revenue generated by the Project for that year in excess of the sales tax revenues generated by the Project in Year (the "Incremental Taxes"). City must then pay to LP the Reimbursement Payments out of the Incremental Taxes within b days of the end of the calendar year.

City may only pay Reimbursement Payments out of the Incremental Taxes. The total Reimbursement Payments may not exceed the Maximum Reimbursement Amount, which is the lesser of (1) Amount 2 plus a "simple interest" factor thereon, computed annually at a rate of c percent per annum beginning on the Reimbursement Date and ending on the date d years from the Reimbursement Date, or (2) Amount 3. City's obligation to make Reimbursement Payments is unconditional provided the Project generates Incremental Taxes. However, the Maximum Reimbursement Amount may be reduced if any Public Improvements are not constructed, conveyed, or maintained for public use, or if any of the job creation requirements under the EDA are not satisfied. City's obligation to make Reimbursement Payments will terminate on the earlier of the date that (1) City pays the Maximum Reimbursement Amount; or (2) is e years from the Reimbursement Date.

While the rights under the EDA may be transferred separately from the Project, LP assigned its rights and obligations under the EDA to JV as part of the acquisition of the Project. Aside from the maintenance of the park and job creation certifications, which are ongoing obligations, the construction and conveyance of the Public Improvements by LP were completed prior to the date that JV acquired the EDA. The failure to satisfy these ongoing park maintenance and job creation certification obligations may reduce the Maximum Reimbursement Amount, but Taxpayer represents that payments under the EDA are otherwise unconditional.

Taxpayer represents that, excluding any right or obligation under the EDA, substantially all assets constituting the Project are qualifying real estate assets under § 856(c)(4). Taxpayer also represents that, excluding the Reimbursement Payments, substantially all income yielded by the Project is expected to qualify under § 856(c)(2) and (3).

For purposes of § 856(c)(2) and (3), Taxpayer represents that it intends to use a method of accounting for income attributable to the Reimbursement Payments that clearly reflects income, and does not intend to use a method that improperly frontloads or backloads Taxpayer's recovery of basis in its interest in the EDA.

Taxpayer requests a ruling under § 856(c)(5)(J)(ii) that amounts included in income that are attributable to the EDA will be treated as qualifying income for purposes of § 856(c)(2). Taxpayer represents that it will treat the amount included in income from the EDA as non-qualifying income for purposes of § 856(c)(3).

## LAW AND ANALYSIS

Section 856(c)(2) provides that in order for a corporation to qualify as a REIT, at least 95 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from sources that include dividends; interest; rents from real property; gain from the sale or other disposition of stock, securities, and real property (including interests in real property); and abatements and refunds of taxes on real property.

Section 856(c)(3) provides that in order for a corporation to qualify as a REIT, at least 75 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from sources that include rents from real property, interest on obligations secured by mortgages on real property or interests in real property, gain from the sale or other disposition of real property (including interests in real property), dividends from REIT stock and gain from the sale of REIT stock, and abatements and refunds of taxes on real property.

Section 856(f)(1) provides that, subject to certain exceptions, for purposes of § 856(c)(2) and (3), the term "interest" does not include any amount received or accrued, directly or indirectly, if the determination of such amount depends in whole or in part on the income or profits of any person.

Section 856(c)(5)(J) provides that to the extent necessary to carry out the purposes of Part II of Subchapter M of the Code, the Secretary is authorized to determine, solely for purposes of such part, whether any item of income or gain which (i) does not otherwise qualify under § 856(c)(2) or (3) may be considered as not constituting gross income for purposes of § 856(c)(2) or (3), or (ii) otherwise constitutes gross income not qualifying under § 856(c)(2) or (3) may be considered as gross income which qualifies under § 856(c)(2) or (c)(3).

The legislative history underlying the tax treatment of REITs indicates that a central concern behind the gross income restrictions is that a REIT's gross income should largely be composed of passive income. For example, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-23 states, "[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business."

Based on the facts and representations presented, including Taxpayer's representation that its income from the Project will predominantly be qualifying income under § 856(c)(2) and (3), treating the income attributable to the Reimbursement Payments as qualifying income solely for purposes of § 856(c)(2) does not interfere with

or impede the objectives of Congress in enacting § 856(c)(2). Accordingly, pursuant to § 856(c)(5)(J)(ii), it is appropriate for the Secretary to determine that income from the Reimbursement Payments is treated as qualifying income for purposes of § 856(c)(2) only.

### CONCLUSION

Based on the facts and representations submitted, we rule that, pursuant to § 856(c)(5)(J)(ii), income attributable to the Reimbursement Payments will be treated as qualifying income for purposes of § 856(c)(2) only.

This ruling's application is limited to the facts, representations, Code sections, and regulations cited herein. Except as specifically ruled upon above, no opinion is expressed concerning any federal income tax consequences relating to the facts herein under any other provision of the Code. Specifically, we do not rule whether Taxpayer qualifies as a REIT under Part II of Subchapter M of Chapter 1 of the Code. Further, we do not rule on the amount, character, or timing of income attributable to the Reimbursement Payments for purposes other than § 856(c)(2).

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. In accordance with the provisions of a Power of Attorney on file, we are sending a copy of this ruling letter to your authorized representatives.

The ruling contained in this letter is based upon information and representations submitted by Taxpayer and accompanied by penalties of perjury statements executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for a ruling, it is subject to verification on examination.

Sincerely,

Andrea M. Hoffenson

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Branch Chief, Branch 2  
Office of the Associate Chief Counsel  
(Financial Institutions and Products)